

INVESTMENT UPDATE

We're taking a somewhat different approach this month, covering two unrelated topics that are of interest to bond investors: US productivity and an overview of the European telecom sector.

The Importance of Being Productive

Productivity normally accelerates as an economy emerges from a recession. This is primarily due to the fact that during a recession companies and agencies make cutbacks and shut down their least efficient operations. Typically measured as output per hour, once economic activity resumes, companies are able to produce more with fewer employees. Additionally, in this environment, there is typically an ample supply of unemployed workers who are eager to work and are highly productive "right out of the gate".

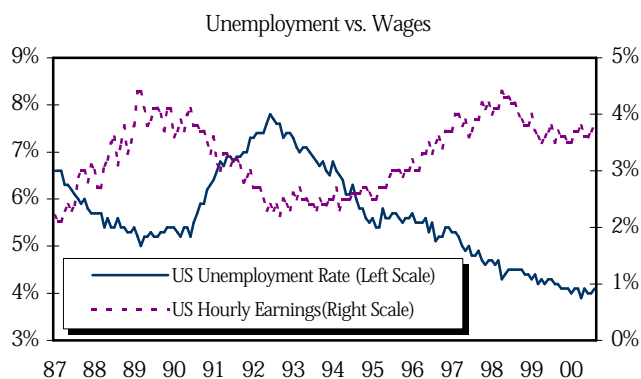
Despite measurement problems (what's the output of a service worker?), productivity is important because it, along with the growth of the labor market, determines the real output of the economy. In other words, even with no growth in the labor pool the economy can generate an additional 1% of product if productivity can be raised by 1%.

The next chart shows the four-quarter moving average of non-farm productivity since 1987. You'll notice the big increase as the US emerged from the last recession in 1990-91. What's most unusual, however, is the dramatic and unexpected increase in productivity in the past two years.



One would expect productivity to be declining at this mature stage in the business cycle.

This surprising increase in productivity is the main reason inflation has remained subdued despite the lowest unemployment rate in 30 years. The next chart shows how there has been, up until recently, a very strong inverse relationship between unemployment and wages—the lower the rate of unemployment (i.e., the tighter the labor market), the greater the upward pressure on wages. That relationship seems to have come unglued over the past couple of years as hourly earnings peaked in 1998, while the labor markets have continued to tighten.



All this is important, of course, because the Federal Reserve has noted the importance of productivity on suppressing wages. In fact, each time Chairman Greenspan speaks, Fed-watchers look to see if he talks "new economy" (the productivity miracle) or "old economy" (the need for vigilance against inflationary pressures). To the extent that productivity takes a leading role in his remarks, he has proven to be more inclined to leave rates alone. When he has spent less time on the benefits of productivity, the Fed has followed up with a rate increase. Keep watching the productivity numbers; they are key to how the Fed proceeds from here.



The Telecoms are Coming!

You may have read about the ongoing European bandwidth auctions that will be used to accommodate the next generation of wireless devices. Known as “third generation” or 3G for short, this technology will allow wireless devices to transmit a huge amount of information, not just phone calls, but messages with full text, graphics, video, and sound, all at high speed. These auctions are being conducted by the governments of each country, either through a competitive bid process or as “beauty contests” where the government sets the price and picks the winners based on the companies’ perceived ability to deliver the goods.

What makes these auctions noteworthy is the amount of money European telecommunications companies are paying for this bandwidth. In the German auction alone six different bidders each paid \$7.6 billion for the right to use these frequencies. Auctions have also taken place, or will soon take place in all the major European countries, including England, France, Italy, The Netherlands and Spain. In total, these auctions are expected to cost the bidders well in excess of \$100 billion. Not included in this number are the build-out costs to implement the technology, estimated at an additional \$50-\$100 billion!

These companies, many the former government-owned phone companies of their respective nations, will get most of their permanent funding to pay for these acquisitions from the bond market. Deutsche Telekom was the first to tap the US bond market to build its war chest for these acquisitions, with the \$9 billion (plus an additional 3.5 billion in euros) issue it floated in June. British Telecommunications tried to follow suit in August, but postponed its bond sale due to a lukewarm reception. Bond investors are nervous about the huge expenditures for a new technology and are demanding that firms have in place a long-range strategy to pay down the accumulated debt and protect bondholders. Standard & Poor’s and Moody’s are finishing up a wholesale review of the industry and have downgraded most of the participants to reflect the new environment.

We believe that our clients may be able to profit from the restructuring in this industry. The new supply of bonds (and anticipation of continued heavy supply) to pay for the licenses has already pushed yield spreads well into “BBB land”, even though many of these companies should maintain ratings of “single-A”. While buying licenses means that these firms will have a heavier debt burden, we believe it is essential for their survival. Wireless technology is not just a passing fancy; especially in Europe, it will be imperative to offer customers the new 3G technology.

